

## Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CEA-01 CIAE-00 COME-00 EB-08  
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SSO-00 USIE-00 INRE-00 XMB-02 /081 W  
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FM USMISSION OECD PARIS  
TO SECSTATE WASH DC IMMEDIATE 5296  
INFO AMEMBASSY ROME

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PASS: CEA, TREASURY, FRB

E.O. 11652: N/A  
TAGS: OECD, ECON

SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC)  
REVIEW OF ITALY: TEXT OF DRAFT SURVEY CONCLUSIONS

REF: EDR(77)4

1. AS FOLLOWUP TO SEPTEL ON EDRC REVIEW OF ITALY, THIS MESSAGE TRANSMITS RELEVANT PORTIONS OF CONCLUSIONS SECTION OF REFDOC. ACTION REQUESTED: MISSION WOULD APPRECIATE WASHINGTON AGENCIES' AND AMEMBASSY ROME'S COMMENTS ON MAIN THRUST OF SECRETARIAT'S ANALYSIS AND POLICY RECOMMENDATIONS. TEXT FOLLOWS.

2. BEGIN TEXT: "TURNING NOW TO THE OVER-RIDING IMMEDIATE PROBLEM OF CORRECTING THE BALANCE OF PAYMENTS DISEQUILIBRIUM AND BREAKING THE INFLATIONARY SPIRAL, THERE IS STILL AN IMPORTANT GAP IN THE OTHERWISE IMPRESSIVE DEFENCE-WORKS THAT ITALY HAS RECENTLY ERECTED. LAST  
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YEAR'S EMERGENCY MEASURES TO COPE WITH THE EXTERNAL DEFICIT (THE IMPORT DEPOSIT SCHEME AND THE TAX ON PURCHASES OF FOREIGN CURRENCY) WERE NO MORE THAN TEMPORARY STOPGAPS, AND ARE RIGHTLY BEING PHASED OUT AS A MORE COHERENT AND EFFECTIVE STABILISATION PROGRAMME STARTS TO BE APPLIED. THE PROGRAMME COMPRISES IMPORTANT MEASURES OF FISCAL AND MONETARY RESTRAINT AND SETS SPECIFIC TARGETS

FOR THE BUDGET DEFICIT, ITS MONETARY FINANCING AND THE RATE OF DOMESTIC CREDIT EXPANSION IN 1977. THESE MEASURES PROBABLY IMPLY A DECLINE OF DOMESTIC DEMAND IN REAL TERMS, BUT THIS SHOULD BE ACCOMPANIED BY AN INCREASE IN THE VOLUME OF NET EXPORTS OF GOODS AND SERVICES. IMPLEMENTATION OF SO RESTRICTIVE A POLICY WILL BE A TEST OF SOCIAL COHESION: AS ITS IMMEDIATE EFFECTS MAY INCLUDE A WORSENING OF BOTH THE EMPLOYMENT SITUATION AND THE FINANCIAL POSITION OF MANY FIRMS. BUT POSTPONEMENT OF UNPALATABLE ACTION WOULD REQUIRE EVEN MORE DRASTIC MEASURES A LITTLE LATER ON. THE BURDEN WILL, OF COURSE, BE ALLEVIATED BY THE EXTENT TO WHICH MEMBER COUNTRIES WITH BETTER BALANCES OF PAYMENTS AND PRICE PERFORMANCES ENSURE AN ADEQUATE GROWTH OF WORLD TRADE. BUT, AS IN THE CASE OF OTHER COUNTRIES IN WEAK POSITIONS, OF WHICH THERE ARE SEVERAL AT THE MOMENT, PRIMARY RESPONSIBILITY FOR ADJUSTMENT MUST REST WITH ITALY.

IT IS CLEAR THAT THE STABILISATION PROGRAMME CANNOT CONSIST SOLELY OF DEMAND MANAGEMENT MEASURES. IN PRESENT CIRCUMSTANCES, DIRECT ACTION TO BREAK THE PERNICIOUS SPIRAL OF NOMINAL INCOMES AND PRICES MUST BE CONSIDERED TO BE OF THE ESSENCE. DISCUSSIONS HAVE TAKEN PLACE BETWEEN THE AUTHORITIES AND REPRESENTATIVES OF INDUSTRY AND LABOUR TO FIND A SOLUTION TO THE PROBLEM OF RISING LABOUR COSTS. THE AGREEMENT OF THE SOCIAL PARTNERS CONCLUDED IN JANUARY PROVIDES FOR WELCOME CHANGES OF WORK RULES IN INDUSTRY WHICH WILL CERTAINLY INCREASE PRODUCTIVITY. IT DOES NOT, HOWEVER, CHANGE AT ALL SIGNIFICANTLY LIMITED OFFICIAL USE

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THE WAGE INDEXATION SYSTEM. AND IF THE PRICE-WAGE SPIRAL CONTINUES IT WILL SOONER OR LATER CREATE NEW PRESSURES ON THE EXCHANGE RATE, EVEN IF REAL DOMESTIC DEMAND IS KEPT LOW. AS THE EVENTS OF 1976 HAVE DEMONSTRATED, PROGRESSIVE DEPRECIATION OF THE CURRENCY EXACERBATES INFLATION AND SERVES THE ECONOMY POORLY. WHAT HAS TO BE RECOGNISED IS THAT AVERAGE LIVING STANDARDS CANNOT EXCEED AVAILABLE RESOURCES AND THAT THE AVERAGE WORKER WILL NOT BE BETTER OFF IF BOTH WAGES AND PRICES RISE BY SOME 20 PER CENT (AS IS FORECAST AT PRESENT FOR 1977). RAPID INFLATION ERODES THE REAL VALUE OF BOTH HIS DISPOSABLE INCOME AND HIS SAVINGS. THERE CAN BE LITTLE DOUBT THAT THE PRESENT WIDESPREAD USE OF INDEXATION IN THE ECONOMY GREATLY ACCELERATES THE PROPAGATION OF INFLATIONARY IMPULSES. AND UNLESS THIS PROCESS IS EFFECTIVELY SLOWED DOWN, THE ONLY WAY OF ACHIEVING THE NECESSARY REDUCTION OF DOMESTIC DEMAND WOULD BE THROUGH AN EXTREMELY RESTRICTIVE MONETARY POLICY - WITH AN UNFORTUNATE DISPROPORTIONATE IMPACT ON INVESTMENT AND THE LEVEL OF FUTURE

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EMPLOYMENT.

CHANGES IN THE PRESENT SYSTEM OF WAGE-INDEXATION ARE, THEREFORE, NECESSARY - WHETHER THROUGH NEGOTIATION BETWEEN THE SOCIAL PARTNERS OR, IF NECESSARY, THROUGH LEGISLATIVE ACTION. IT IS OBVIOUS THAT ANY IMPORTANT AMENDMENT OR SUSPENSION OF INDEXATION CLAUSES MAY RESULT IN SOME TEMPORARY DECLINE IN REAL HOURLY WAGES. BUT THE SAME EFFECT ON THE TOTAL REAL WAGE BILL WOULD ALMOST CERTAINLY RESULT, ON A MORE DISCRIMINATORY BASIS, FROM THE PRESENT INFLATIONARY MECHANISM. IN CERTAIN SECTORS - E.G. IN PUBLIC SERVICES - THE INDEXATION OF SALARIES IS LESS COMPREHENSIVE THAN IN INDUSTRY; AND MANY FIRMS THAT CANNOT BEAR THE SOARING COST OF LABOUR WOULD HAVE TO REDUCE EMPLOYMENT. MOREOVER, IF RAPID INFLATION PERSISTS, FISCAL DRAG WILL REDUCE THE DISPOSABLE INCOME OF WAGE AND SALARY-EARNERS MORE QUICKLY THAN THAT OF THE SELF-EMPLOYED, WHOSE INCOMES ARE NOT FULLY ASSESSED FOR TAX PURPOSES. OVER THE LONGER RUN, ACCELERATING INFLATION AND A DEPRECIATING CURRENCY WILL NOT SPARE ANY IMPORTANT

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SOCIAL GROUP.

SOME STEPS WERE TAKEN VERY RECENTLY TO LIMIT THE SHARP RISE OF LABOUR COSTS IN INDUSTRY AND TO DAMPEN THE AUTOMATIC EFFECT ON WAGES OF POLICY-INDUCED PRICE INCREASES. THESE MEASURES, HOWEVER, ARE ESSENTIALLY OF A TEMPORARY NATURE. THE MORE IMPORTANT RECENT DECISION IS A PARTIAL "BUDGETISATION" OF EMPLOYERS' SOCIAL SECURITY CONTRIBUTIONS, TO BE FINANCED MAINLY BY INCREASES IN THE VALUE-ADDED TAX, WHICH WOULD NORMALLY TEND TO ACCELERATE INFLATION STILL FURTHER. THE AUTHORITIES EXPECT, HOWEVER, THIS RISK TO BE SUBSTANTIALLY REDUCED BECAUSE OF THE CHOICE OF PRODUCTS ON WHICH THE VAT INCREASES APPLY AND BECAUSE OF THE DECISION THAT PRICE RISES RESULTING FROM THE INCREASED VAT RATES WILL BE EXCLUDED FROM THE CALCULATIONS OF THE SLIDING-SCALE FOR WAGES. THE LATTER PROVISION, SUBJECT TO APPROVAL BY PARLIAMENT WITHIN THREE MONTHS, CONSTITUTES AN IMPORTANT INNOVATION OF PRINCIPLE BUT ITS SHORT-TERM QUANTITATIVE IMPACT IS UNCERTAIN. IT IS FORESEEN TO REVIEW THE EFFECTS OF ALL THESE MEASURES IN THE MIDDLE OF 1977 AND IT WOULD SEEM VERY DESIRABLE TO PREPARE IN THE MEANTIME MORE COMPREHENSIVE AND LASTING SOLUTIONS TO THE PROBLEM OF THE PRICE-WAGE SPIRAL.

PUBLIC DISCUSSION OF ITALY'S ECONOMIC PROSPECTS, BOTH INSIDE AND OUTSIDE THE COUNTRY, HAS RECENTLY TENDED TO BE EXCESSIVELY PESSIMISTIC. SOME RATHER TOUGH MEASURES, IN THE SHORT RUN, ARE NECESSARY; AND SOME IMPORTANT BASIC REFORMS ARE REQUIRED IF THESE TOUGH MEASURES ARE TO BE SUCCEEDED BY LONGER-RUN SUCCESS. BUT THERE IS NO VALID TECHNICAL REASON FOR DOUBTING THAT ITALY'S ECONOMIC PROBLEMS CAN BE SOLVED IF THE NECESSARY INTERNAL CONSENSUS CAN BE OBTAINED. AND INTERNATIONAL FLANKING SUPPORT TO ADEQUATE ACTION BY THE ITALIAN AUTHORITIES TO TRANSLATE THAT CONSENSUS INTO EFFECTIVE ACTION WILL CERTAINLY BE FORTHCOMING. IT IS NOT SUGGESTED THAT A PROTRACTED LIMITED OFFICIAL USE

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PERIOD OF STAGNATION IS INCUMBENT UPON THE ITALIAN ECONOMY, BUT ONLY THAT A CREDIBLE STABILISATION PROGRAMME - INCLUDING EFFECTIVE MEASURES TO ARREST THE PRESENT INFLATIONARY SPIRAL - SHOULD BE APPLIED

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IN THE NEAR FUTURE AND ESPOUSED BY THE SOCIAL PARTNERS.  
GIVEN SUCH A PROGRAMME, THE PERIOD OF ADJUSTMENT COULD  
BE SHORT AND COULD SOON ENABLE ECONOMIC GROWTH TO BE  
RESUMED ON A MORE ENDURING BASIS. WHEN THE ECONOMY IS  
AGAIN GROWING AT A REASONABLY FAST RATE AND TOTAL EMPLOY-  
MENT IN THE PRODUCTIVE SECTORS IS INCREASING, IT WILL  
NATURALLY BE EASIER TO CORRECT PROGRESSIVELY THE NUMEROUS  
EXISTING DISTORTIONS AND TO SOLVE THE COUNTRY'S MEDIUM-  
TERM STRUCTURAL PROBLEMS. BUT ACTION AIMED AT LONGER-  
TERM OBJECTIVES CAN BE INITIATED ALREADY; AND THIS WOULD  
PROBABLY HELP TO OBTAIN ACCEPTANCE OF THE TEMPORARY AUS-  
TERITY PROGRAMME BY BROAD SECTORS OF SOCIETY. ITALY'S  
MEDIUM-TERM PROBLEMS MAKE UP A LONG LIST: THE NEED TO  
RENOVATE LARGE SECTORS OF INDUSTRY, EXPAND PRODUCTIVE  
INVESTMENT AND STRENGTHEN THE PATTERN OF EXPORTS; THE  
BACKWARDNESS OF CERTAIN AGRICULTURAL SECTORS; THE LARGE  
AND PERSISTENT IMBALANCES, ESPECIALLY BETWEEN NORTH AND  
SOUTH; THE PROBLEMS OF LOW-COST HOUSING, URBAN PLANNING  
AND INADEQUATE SOCIAL INFRASTRUCTURES; BASIC REFORMS IN  
PUBLIC FINANCE AND IN THE FUNCTIONING OF THE PUBLIC  
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ADMINISTRATION; MODERNISATION OF COMPANY LAW AND ACCOUNT-  
ING RULES AND THE IMPROVEMENT OF THE CAPITAL MARKET, ETC.

IF EFFECTIVE MEASURES ARE TAKEN TO BRING INFLATION UNDER CONTROL AND PROGRESS IN THESE AREAS BEGINS, THE BALANCE OF PAYMENTS PROBLEM WILL BE SEEN TO BE BY NO MEANS INSOLUBLE, EVEN IF SPECIAL ARRANGEMENTS ARE NEEDED TO COPE WITH ACCUMULATED FOREIGN DEBT. THE FUNDAMENTAL REQUIREMENT AT PRESENT IS TO OBTAIN SOCIAL CONSENSUS FOR A COHERENT PROGRAMME THAT INCLUDES THE AUSTERITY TEMPORARILY INEVITABLE BUT WHICH ALSO FEATURES ACTION TO SUPPORT EMPLOYMENT LEVELS AND PROMOTE INVESTMENT, PARTICULARLY IN THE WORSE-OFF REGIONS AND SECTORS. AND IN DESIGNING THIS PROGRAM, THE FULLEST POSSIBLE ATTENTION MUST BE PAID TO THE MEDIUM-TERM REQUIREMENTS OF THE ITALIAN ECONOMY." END QUOTE  
TURNER

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